National Bank of Ukraine

Ukraine: Macroeconomic and Policy Outlook

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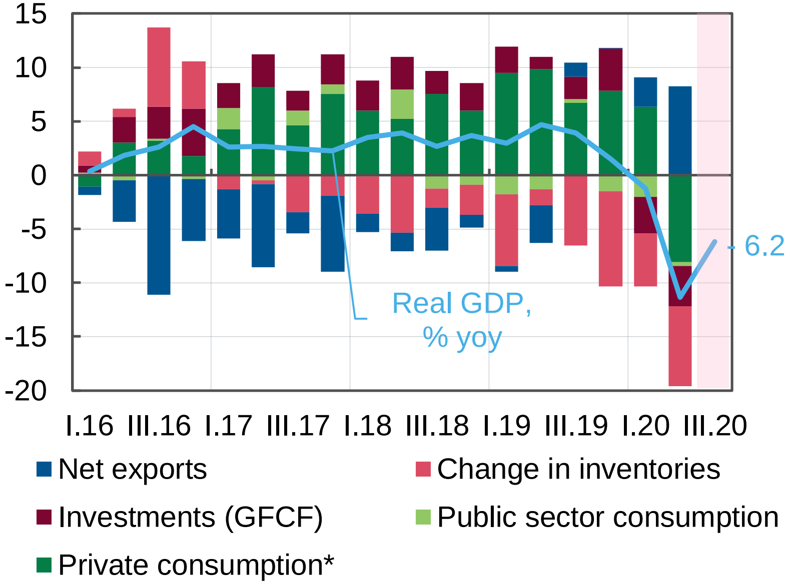
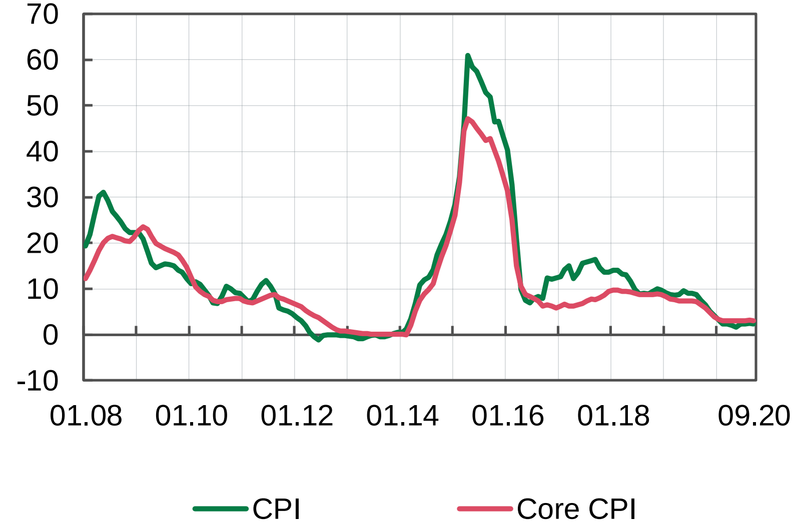
Ukraine entered the Covid-19 crisis with more solid fundamentals compared to previous crisis episodes

Contributions to annual GDP growth by final use, pp



* Including non-profit institutions serving households.
Source: SSSU, NBU staff estimates.

Headline and core inflation, % yoy

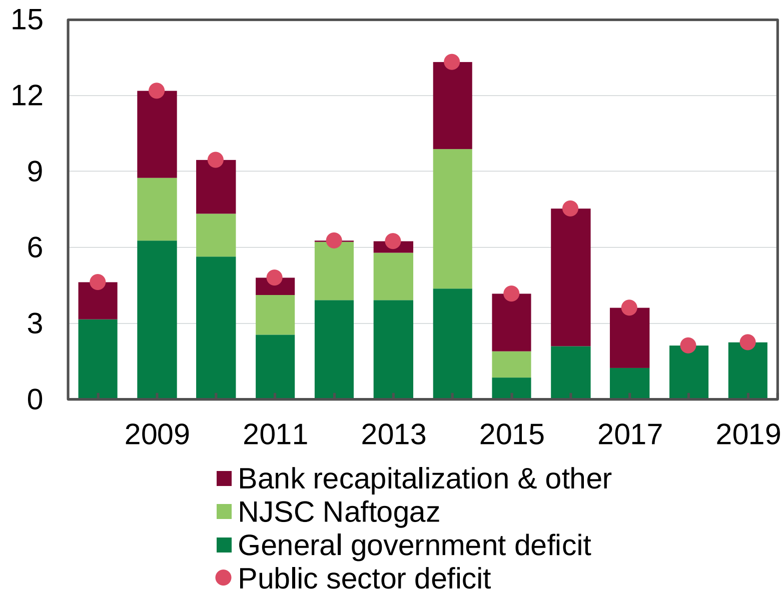


Source: SSSU.

- Ukraine faced 2008-09 crisis with overheated economy and a double-digit inflation. The economy was stagnating in 2012-2013
- Unlike the previous episodes, during 2016-2019 Ukraine's economy were growing at a sustainable 3-3.5% per year, while inflation reached the target of 5% ± 1 pp by the end of 2019

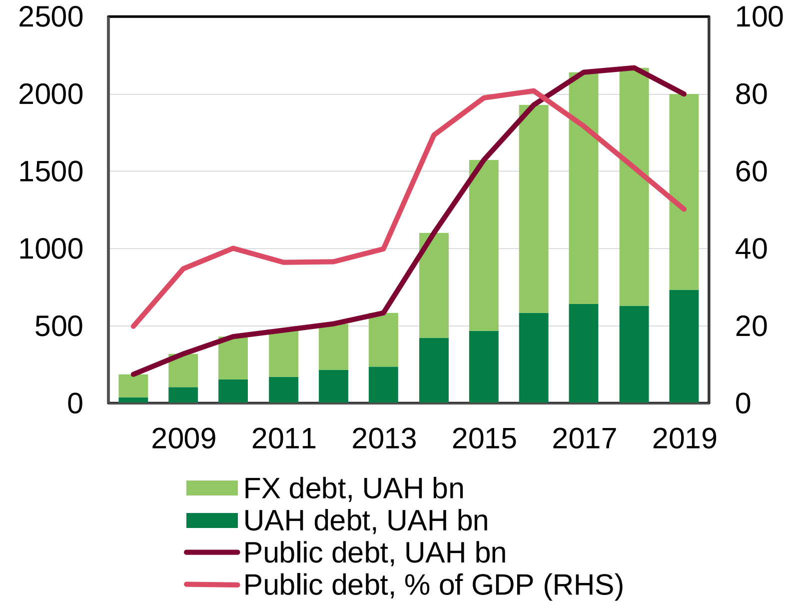
Public finances were brought under control thanks to elimination of quasi-fiscal deficits and improvements in debt management

Broad public sector deficit, % GDP



Source: Treasure, MFU, IMF, SSSU, NBU staff estimates.

Public and publicly guaranteed debt

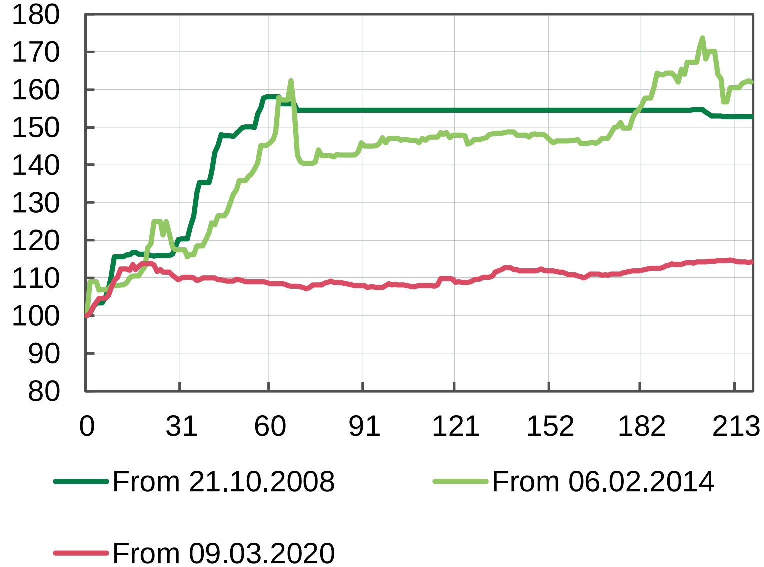


Source: MFU, SSSU, NBU staff estimates.

- Over the last five years Ukraine managed to achieve a breakthrough in eliminating large quasi-fiscal deficits of the energy and banking sectors that added to past macroeconomic imbalances
- Moreover, fiscal consolidation measures, sustainable economic growth and improving debt management practices aimed at de-dollarization and reductions of the borrowing costs, helped bring the debt-to-GDP ratio to just slightly above 50% of GDP as of end-2019

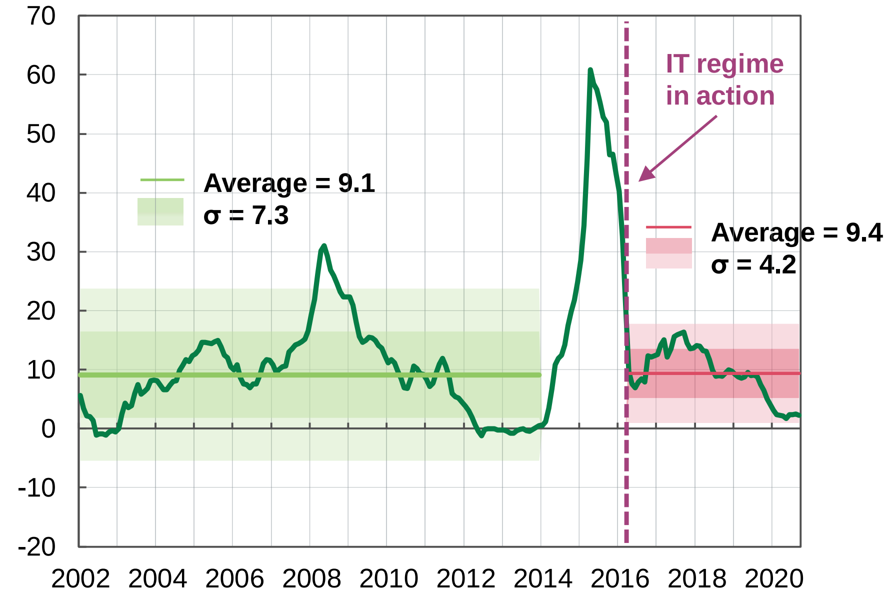
Unlike the previous crisis episodes, this one is not accompanied by devastating depreciation and skyrocketing inflation

Official UAH/USD exchange rate*, beginning of the crises = 100



* X axis indicates the number of calendar days from the beginning of the crisis.
Source: NBU staff estimates.

Inflation volatility

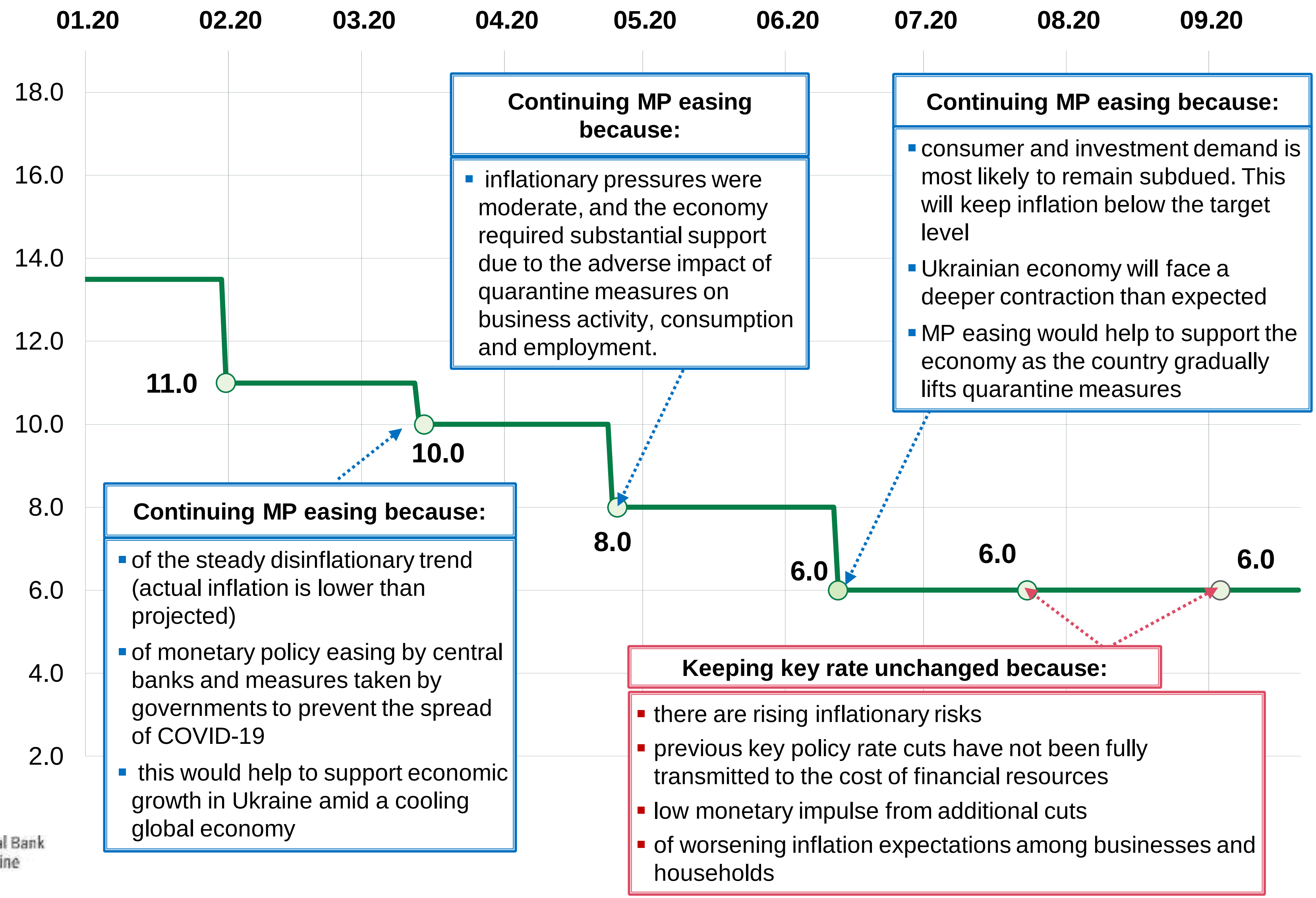


σ – standard deviation, dark color marks one standard deviation, light one – two standard deviations.
Source: SSSU, NBU.

- Ukraine was running moderate inflation at the end of 2019 – the beginning of 2020 amid stable real GDP growth and robust growth in consumer demand
- Further disinflation was driven by lower energy prices and the continued pass-through of last year's appreciation of the hryvnia
- The key difference is the IT regime, resting on a floating exchange rate, which serves as a cushion against adverse shocks

The NBU has cut the key policy rate to its lowest level in Ukraine’s history

Key rate, %



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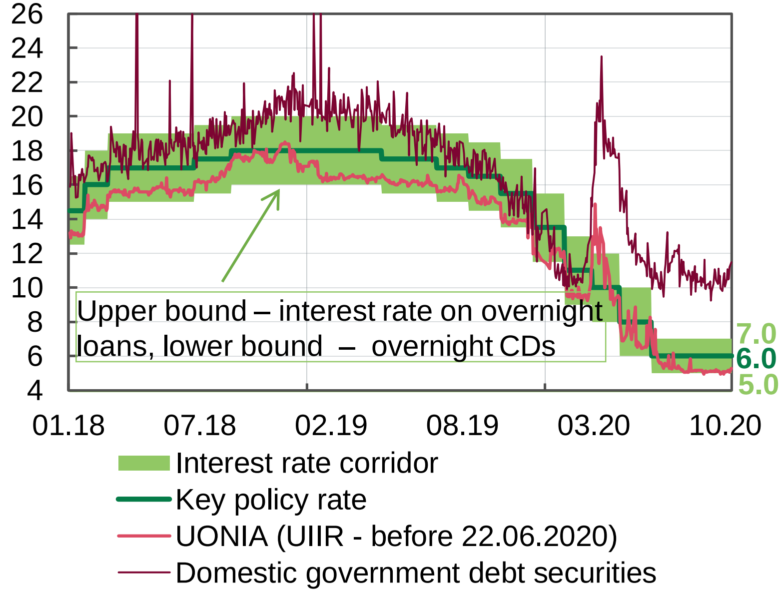
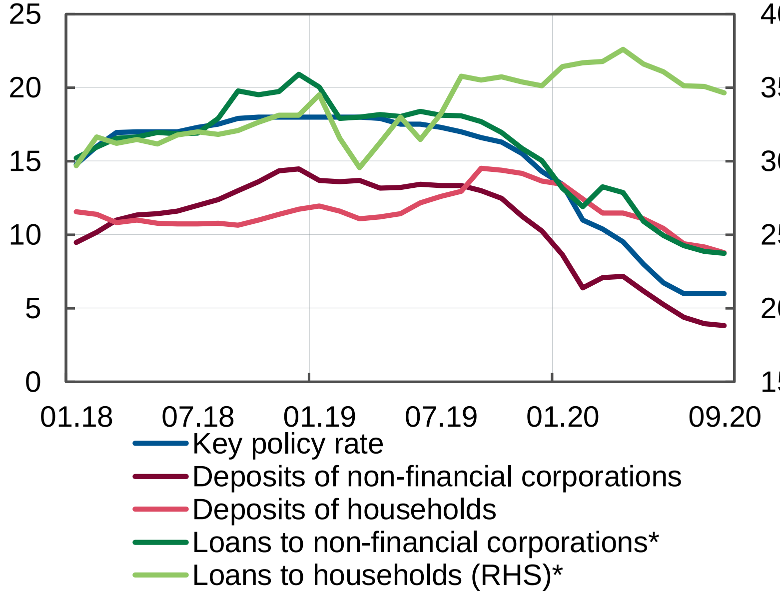
The cost of funds in financial markets has decreased responding to monetary policy easing

NBU policy rates, UIIR/UONIA and government debt securities yields on the secondary market*, %



* As of 12.10.2020.
Source: NBU.

Key policy rate, interest rates on new hryvnia loans and deposits, %



* Excluding overdraft.
Source: NBU.

- The accelerated cuts by the NBU in H1 2020 brought its key policy rate in real terms below the neutral level, making the monetary policy accommodative
- The cuts in the key policy rate were effectively transmitted into interbank rates, which hovered just above the lower bound of the NBU interest rate corridor
- The cost of funds in financial markets needed some time to respond and continued to reflect the cuts of the key rate in the subsequent months
- The lending rate for non-financial corporations has already fallen to an all-time low

The NBU introduces new instruments to support the economy

Updated operational design of monetary policy – to give banks greater flexibility in managing their liquidity**:**

- standing facilities are now offered twice as often as before
- the maturity of CDs has been shortened (from 14 to 7 days)
- the maturity of refinancing loans has been extended to 90 days (from 14 to 30 initially)
- the interest rate corridor has been narrowed to +/- 1 pp (from its previous 2 pp)

Extended eligible collateral: government-guaranteed corporate bonds and municipal bonds can be included in the collateral pool

Upgraded required reserves calculations – an extra UAH 5 bln in liquidity has been released

Long-term refinancing loans with maturities of up to five years – are now provided at a floating interest rate, under the same collateral as for other refinancing loans

FX swap with EBRD – a USD 0.5 bn FX swap facility was agreed on May 7, 2020 in order to provide hryvnia funds for lending to businesses and municipalities

Interest rate swap introduced as a new instrument for banks to manage interest rate risks

NBU measures taken to mitigate the fallout from the crisis

The National Bank of Ukraine:

- relaxed requirements on credit risk assessment – loans restructured due to quarantine-related restrictions will not have a negative impact on banks' capital
- temporarily suspended:
  - requirements on building up capital buffers
  - requirements on the assessment of property collateral
  - inspections of banks
- extended deadlines for submitting reports and financial statements
- postponed certain requirements for banks, including:
  - IT-solutions for risk management systems and NPL management processes
  - stress testing and SREP assessment
- recommended banks refrain from dividend distribution – this should help banks maintain the capital needed for lending recovery
- arranged cash quarantine

The National Bank of Ukraine and banks:

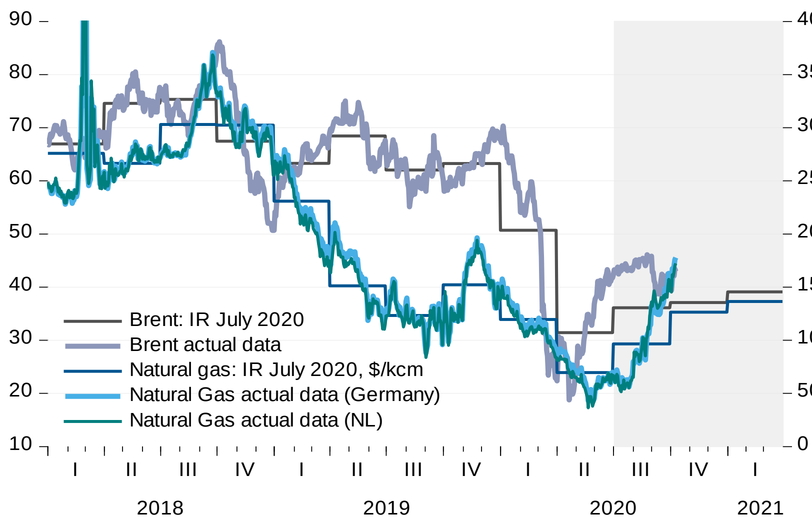
- arranged cash delivery and met demand for FX cash

With the NBU support, banks:

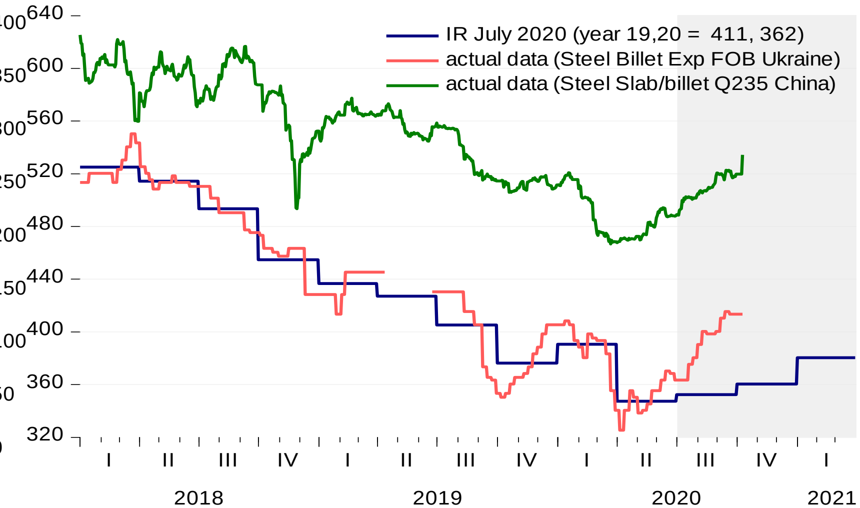
- offered "loan payment holidays" and launched restructuring of loans to crisis-hit borrowers
- reduced commission on cashless transactions and promoted cashless payments

The gradual intensification of economic activity, coupled with some supply side effects, is supporting world prices

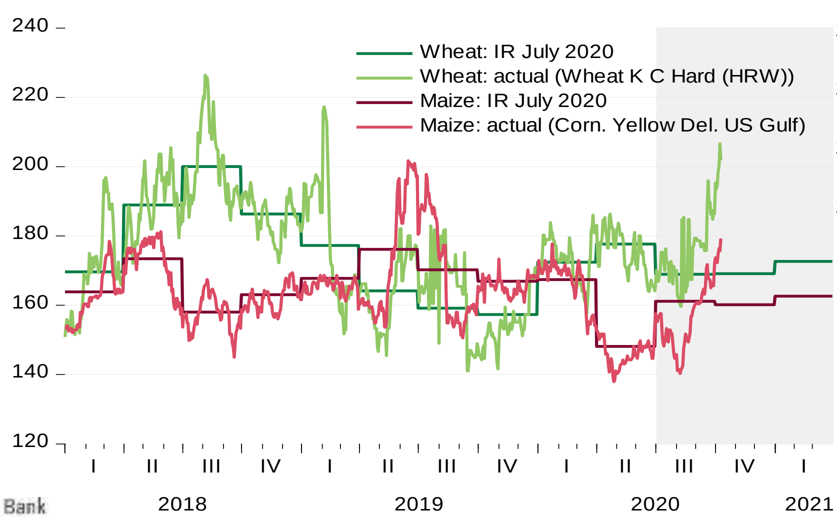
Brent and Natural Gas World Price



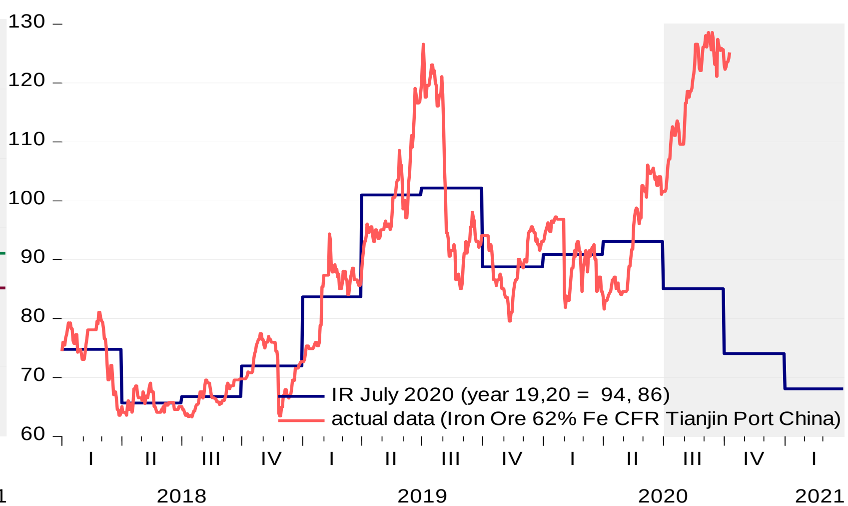
Steel World Price, USD/MT



Wheat and Maize World Prices, USD/MT



Iron Ore World Price, USD/MT



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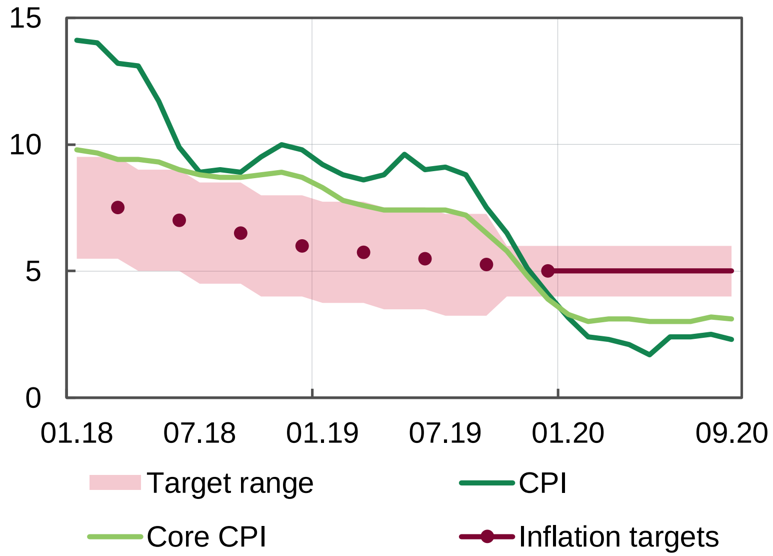
Source: Refinitiv, NBU staff estimates, IR July 2020.

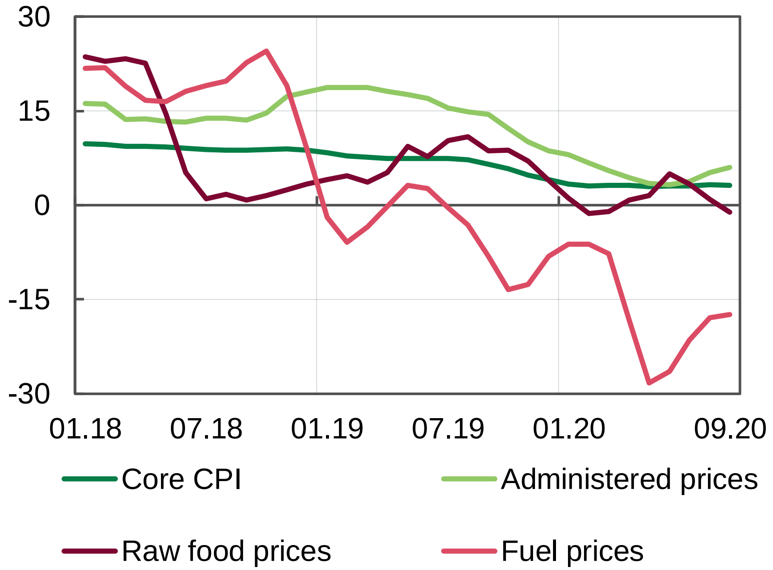
Headline inflation remains subdued in 2020

Headline and core inflation, % yoy



Source: SSSU, NBU.

CPI components, % yoy

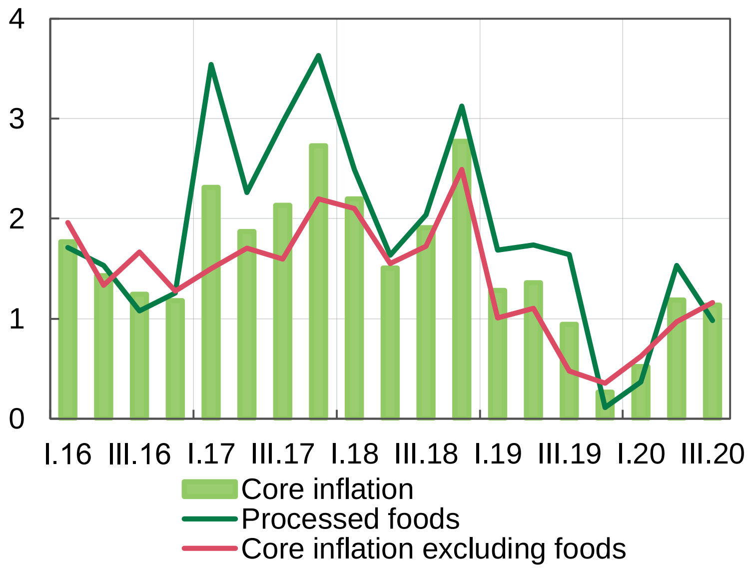


Source: SSSU, NBU staff estimates.

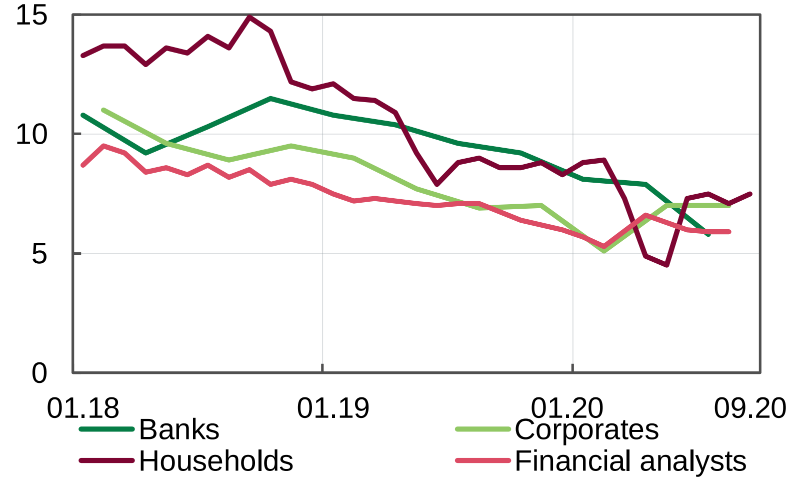
- Consumer inflation hovered at 2.0% - 2.5% yoy since February (2.3% yoy in September) suppressed by lower domestic demand, a sharp decrease in energy prices and rapidly slowing food inflation due to several supply side effects
- Lagged effects of end-2019 hryvnia appreciation and favorable FX market developments in March-April despite the crisis were important factors
- A deeper data reading, however, reveal a gradual build-up of inflation pressures

There are signs that some of the disinflation pressures present in H1 2020 are reversing, however, they are offset by food disinflation

Main components of core CPI, sa, % qoq

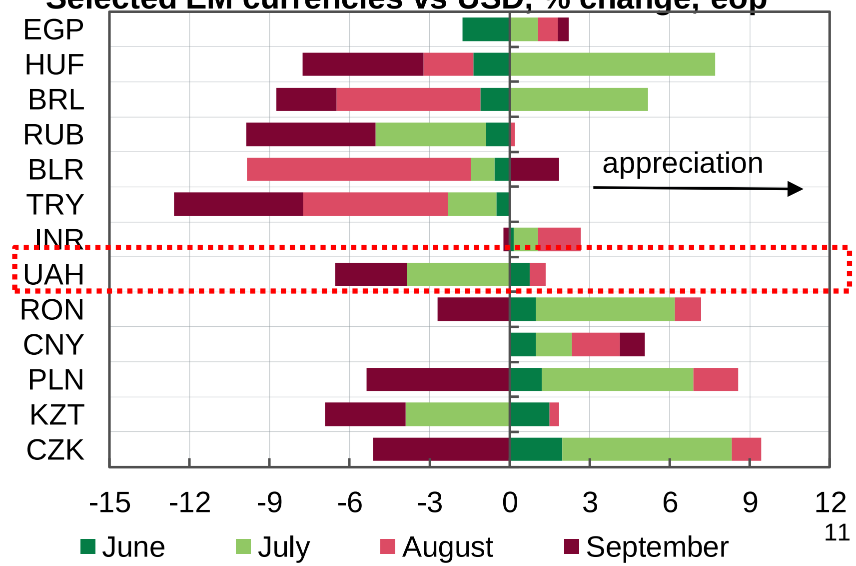


Inflation expectations for the next 12 months, %



Source: NBU, GfK Ukraine, Info Sapiens surveys.

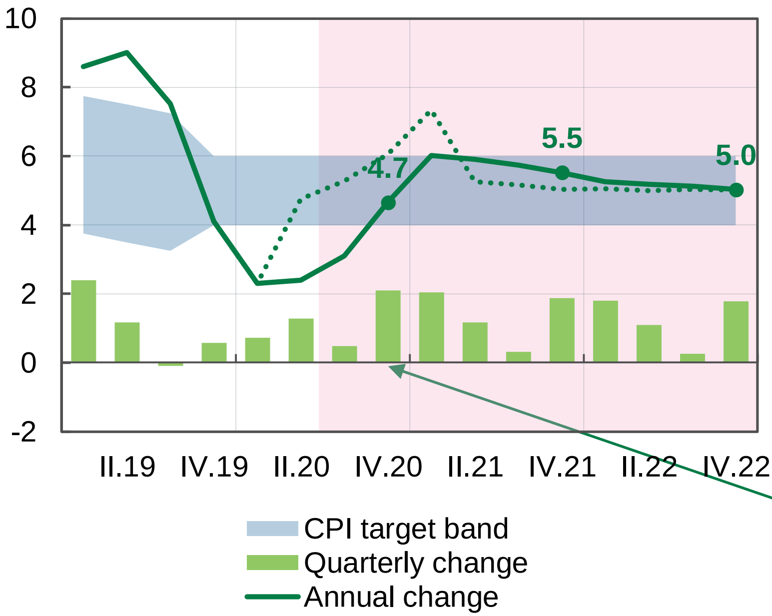
Selected EM currencies vs USD, % change, eop



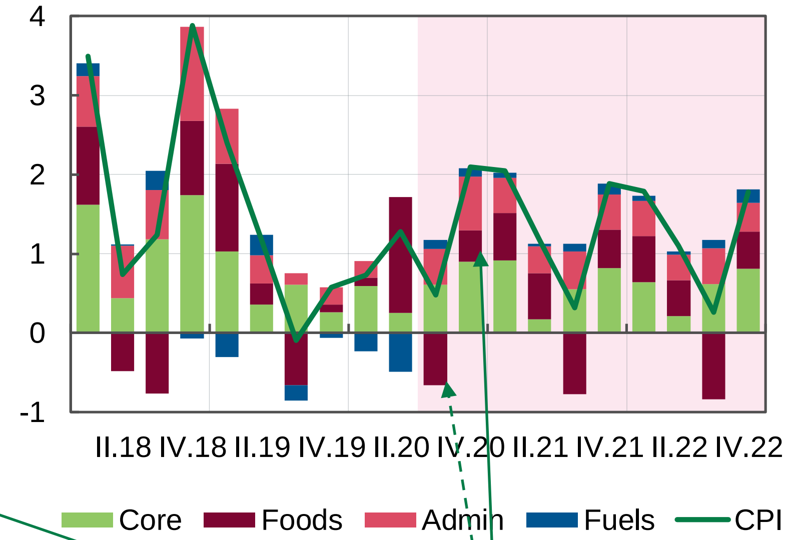
- More ample supply of certain animal products, including through imports, slowed down the growth of food prices
- A faster recovery of consumer demand kept services price inflation high
- The moderate hryvnia depreciation since mid-summer is yet to pass through to consumer prices
- The recovery of world energy prices puts pressure on domestic energy prices
- Inflation expectations remained elevated

Inflation will accelerate on the back of a recovery of demand but will remain within the target range

Headline CPI, %



Contributions to CPI, pp



Source: SSSU, NBU staff calculations, IR July 2020.

change, %	*weight, %*	**2019**	**2020**		**2021**		**2022**	
CPI	***100.0***	**4.1**	**4.7**	*6.0*	**5.5**	*5.0*	**5.0**	*5.0*
Core CPI	*59.4*	3.9	4.0	*6.8*	4.2	*3.8*	3.9	*3.8*
Raw food	*19.4*	3.9	6.5	*5.6*	4.5	*3.3*	3.3	*3.3*
Admin	*18.0*	8.6	7.5	*7.5*	9.9	*9.8*	9.1	*9.2*
Fuel	*3.2*	-8.2	-16.0	*-16.6*	10.5	*12.5*	12.1	*14.0*

Inflation jumped in Q4 due to seasonal effects of raw foods prices

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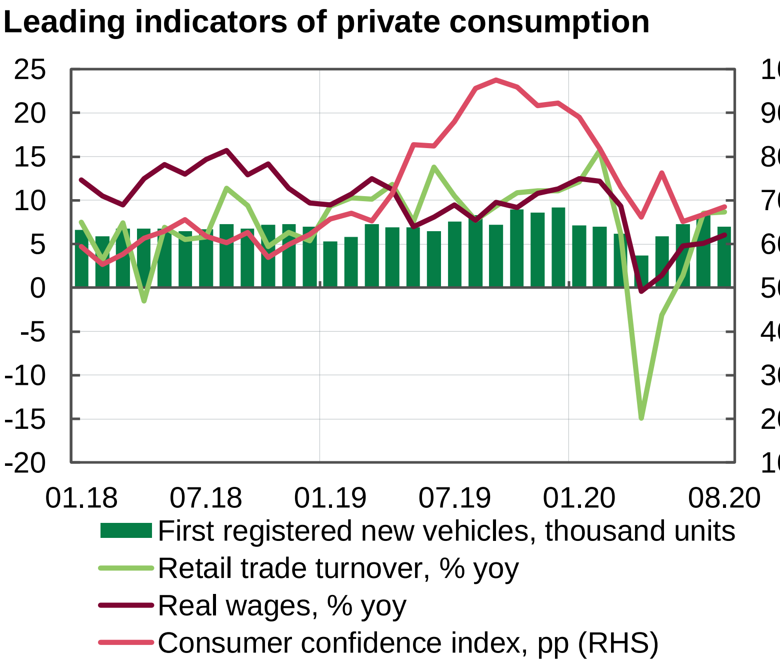
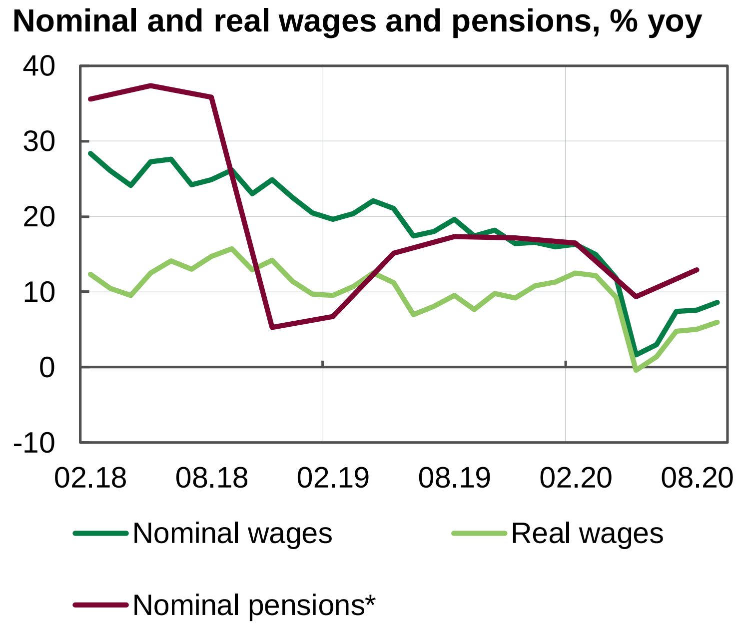
Consumption showed signs of prompt recovery



Source: SSSU, Ukravtoprom, NBU staff estimates.



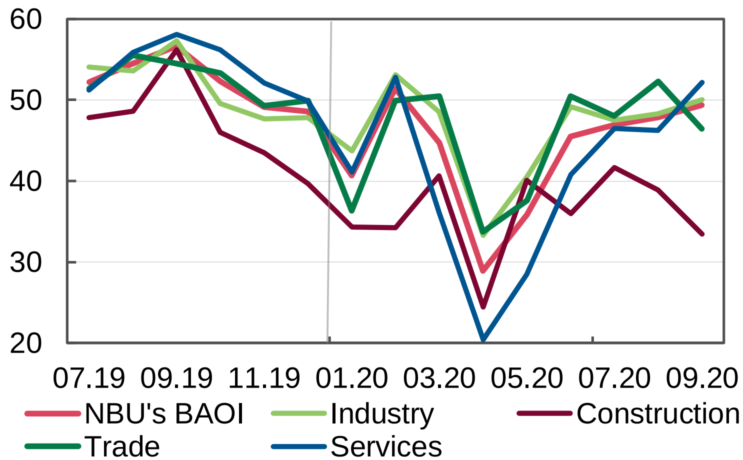
*On 01.07.2020

Source: SSSU, PFU.

- Retail sales, the closest proxy for private consumption, returned to growth in June (+1.4% yoy) after a sharp decrease in April, and the growth accelerated to 8.7% yoy in August
- Other high-frequency indicators (e.g. purchases of new vehicles) support this view as well
- The growth was supported by growing real and nominal wages (by 6% yoy and 8.6% yoy, respectively, in August) and an increase in pension benefits
- Pension benefits, which are the main source of income for about 1/4 of the population, grew fast due to lump-sum payments and the indexation of pension benefits

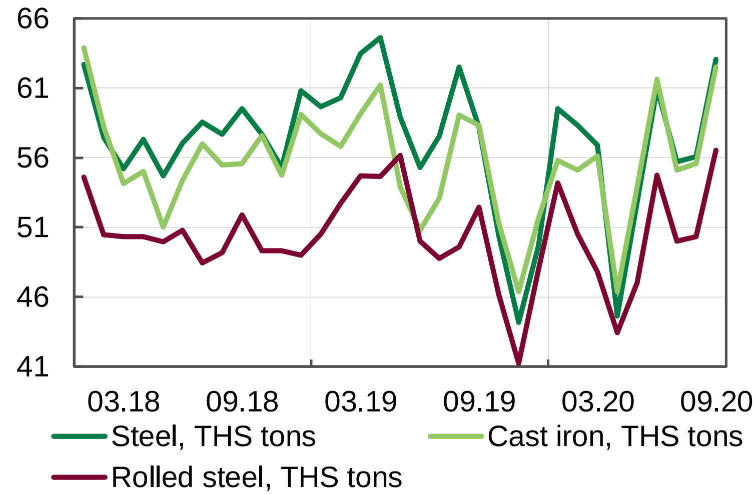
High-frequency indicators point to the economy recovery, but uneven

Dynamics of NBU's business activity outlook index*



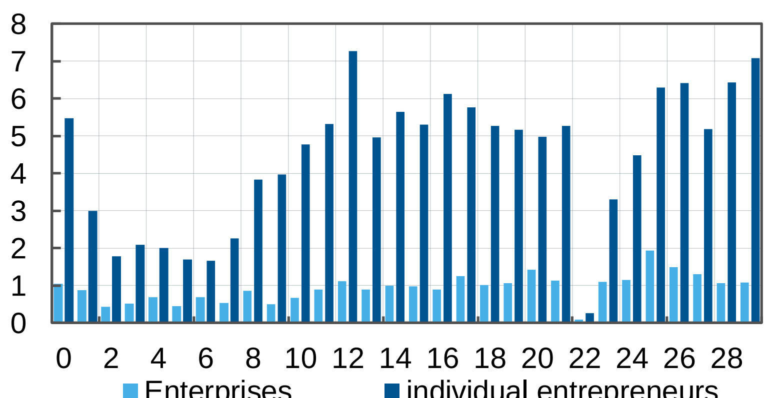
* A level above 50 indicates an expansion or growth compared to the previous month; values below 50 represent a contraction; a level of 50 indicates no change.
Source: NBU.

Average daily production of steel, cast iron, rolled steel

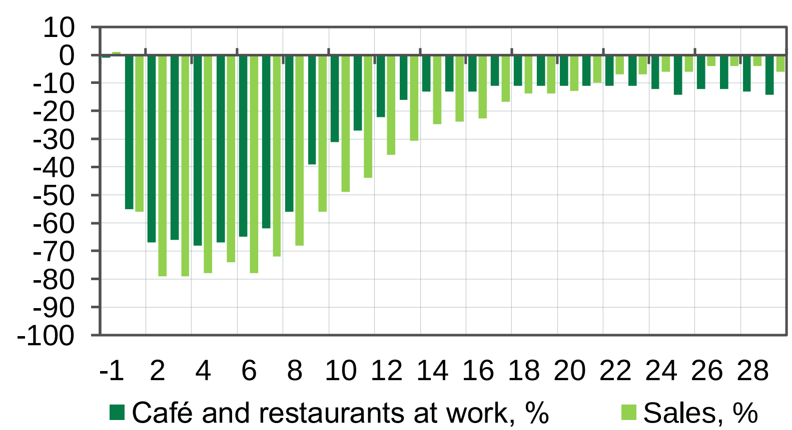


Source: Ukrmetalurgprom.

New business registrations, ths.**



Changes in the number of cafés and restaurants operating and their sales, % to pre-quarantine level



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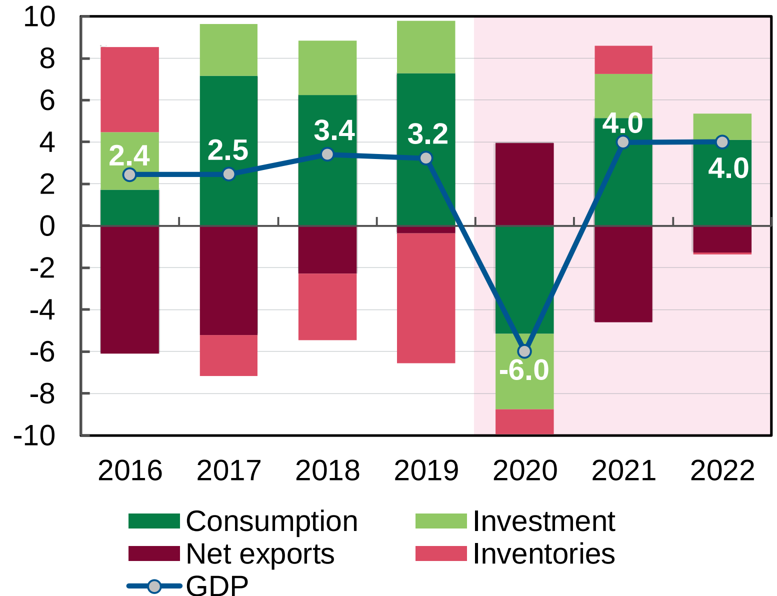
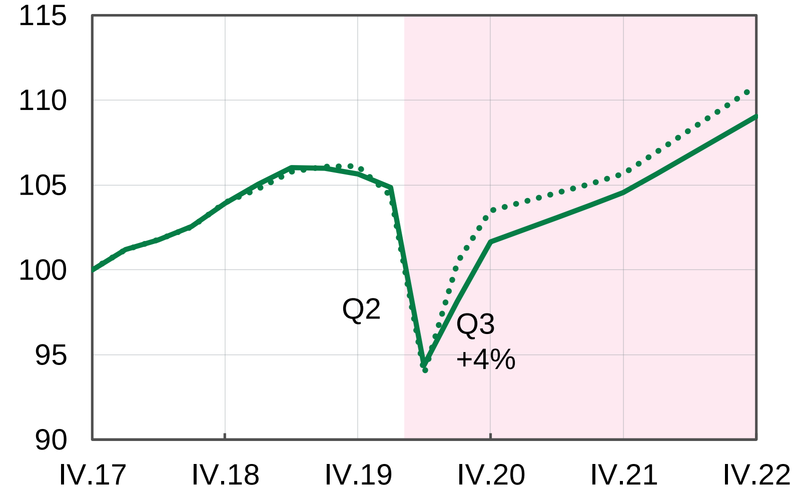
** 0 - week from 9 to 15 March 2020. Source: opendatabot, NBU calculations.

GDP growth will drop by 6% in 2020 due to quarantine effects and shrinking global demand, recovering to about 4% in 2021 and 2022

Growth in Real GDP, %



Real GDP level, seas. adj., IV.2017 = 100



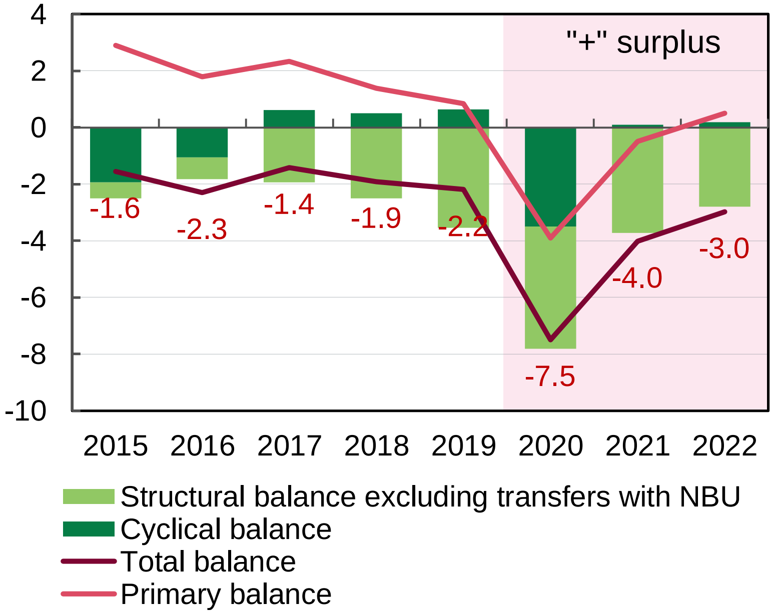
Source: SSSU, NBU staff calculations, IR July 2020 (dashed line – IR April 2020).

	Weight, %	2019	2020	2021	2022
GDP	100	**3.2**	**-6.0**	**4.0**	**4.0**
Consumption	87	8.1	-5.4	5.3	4.3
Private consumption	66	11.3	-6.0	6.0	5.0
Gross fixed capital formation	16	14.2	-20	14.5	8.1
Exports of G&S	48	6.7	-4.7	4.5	3.9
Imports of G&S	56	6.3	-12	14.6	6.1

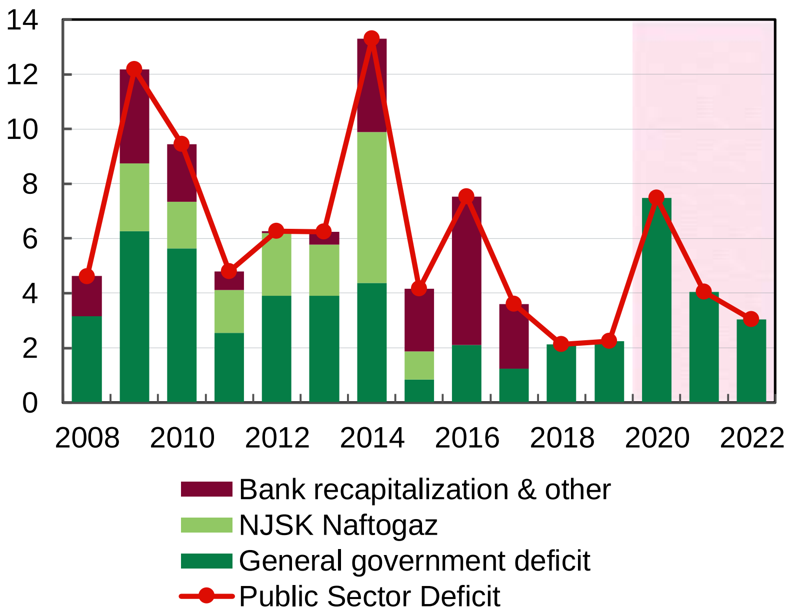
- The growth in GDP will be supported by loose monetary and fiscal policies and recovering external demand

Past fiscal consolidation measures and elimination of quasi-fiscal deficits created some space for fiscal stimulus

Consolidated Budget Balance, % of GDP



Public sector deficit and public debt, % of GDP

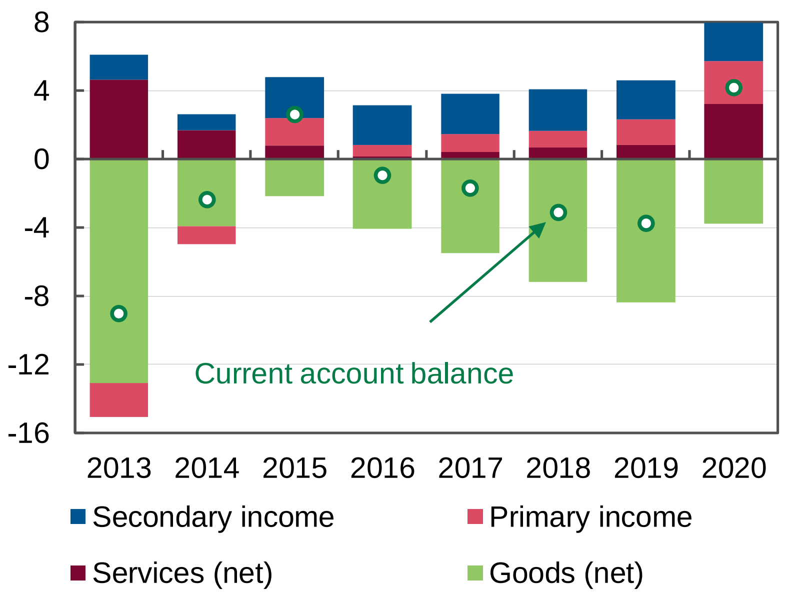


Source: IMF, STSU, MFU, NBU staff calculations, IR July 2020.

- Despite the widening of consolidated fiscal deficit in 2020, the overall public sector deficit (including social funds, Naftogaz and banking sector recapitalization) will stay relatively moderate in comparison to previous crises
- The public debt-to-GDP ratio will increase in 2020 (to 62%), but will decrease afterward thanks to sound fiscal policy, economic growth, and improving debt management practices

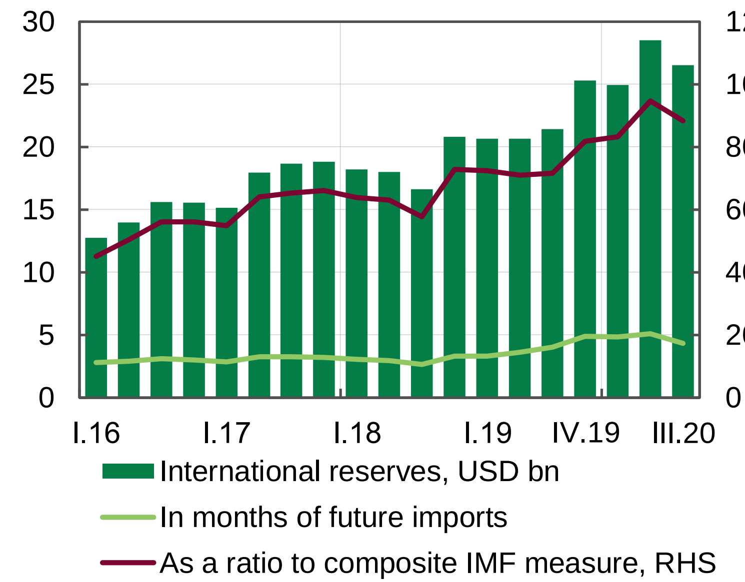
CA ran a record high surplus, more than covering FA outflows. Along with IMF tranche, this allowed reserves to increase

Current account in Jan-Aug, USD bn



Source: NBU.

Gross international reserves

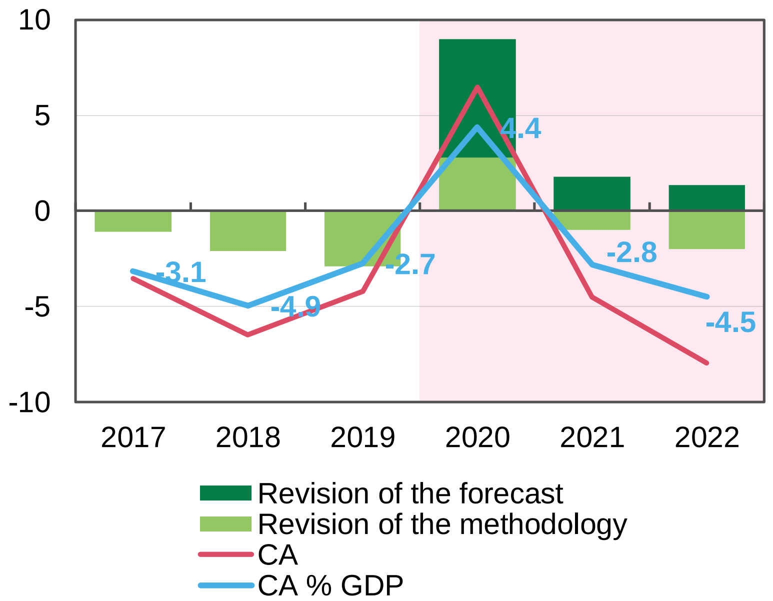


Source: NBU.

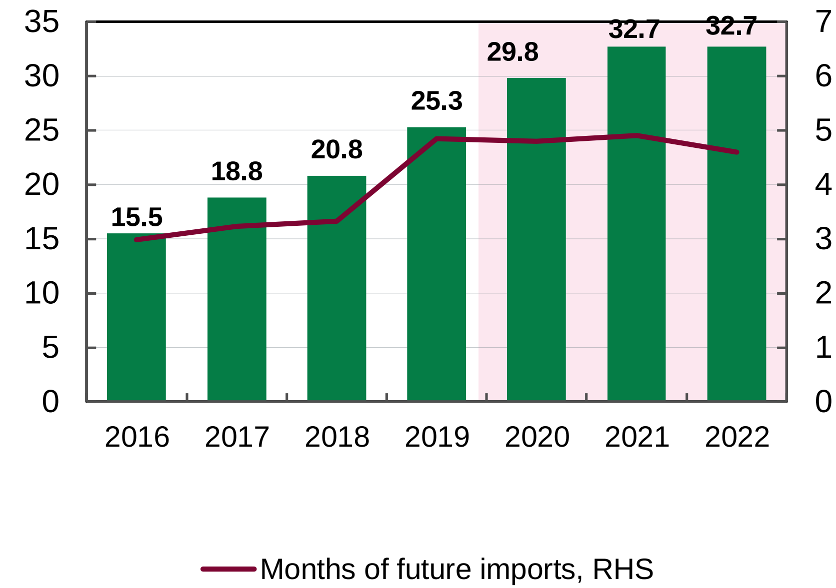
- In Jan-Aug 2020, the CA balance ran a record high surplus as exports turned to be more resilient than imports
- The trade surplus in services widened through a significant decrease in imports of services due to the halt in tourism
- CA surplus more than covered FA outflows generated by private sector. A surplus in the overall BoP along with the IMF tranche disbursal led to an increase in gross international reserves to an 8-year maximum. After peak debt repayments in September reserves were still higher than in the end of 2019

In 2021-2022, FA inflows will cover the CA deficit, therefore reserves will grow

Current Account Balance, USD bn



International Reserves, USD bn



Source: NBU, NBU staff calculations, IR July 2020.

- The CA will turn to deficit in 2021-2022 deferred consumer and investment demand is realized and natural gas transit declines as anticipated
- In 2021-2022, inflows of debt and investment capital to the private sector will renew amid the recovery of the global economy
- Funding from the IMF and other official international partners will help Ukraine significantly build up its international reserves to almost 100% of the IMF criterion by the end-2020

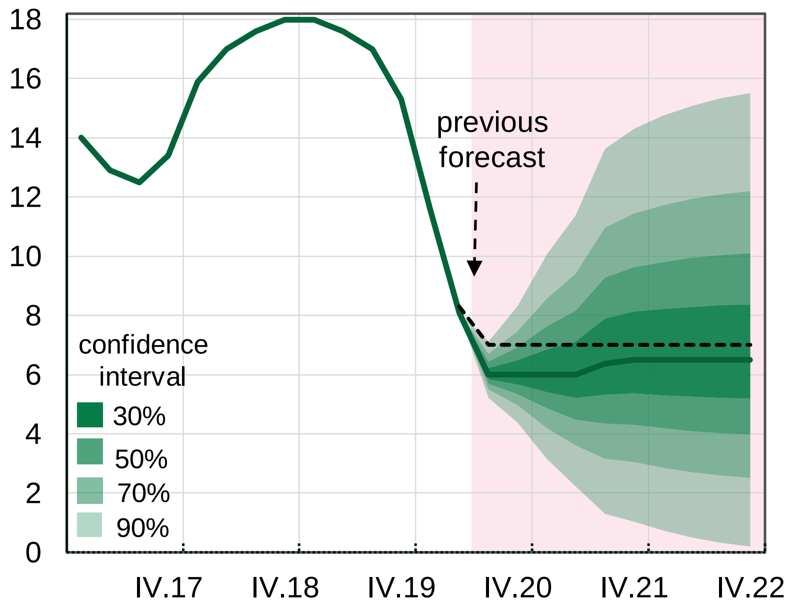
Macroeconomic forecast

	2019	2020 forecast	2021 forecast	2022 forecast
Real GDP, change, %	3.2	-6.0	4.0	4.0
Nominal GDP, UAH bn	3 975	3 910	4 300	4 710
CPI, yoy, %	4.1	4.7	5.5	5.0
Core CPI, yoy, %	3.9	4.0	4.2	3.9
Current account balance, USD bn	-4.1 [-1.3*]	6.5 [4.0*]	-4.5 [-3.5*]	-7.9 [-5.9*]
% GDP	-2.7 [-0.9*]	4.4 [2.7*]	-2.8 [-2.2*]	-4.5 [-3.5*]
BoP (overall), USD bn	6.0	1.5	2.4	1.8
Gross reserves, USD bn	25.3	29.8	32.7	32.7

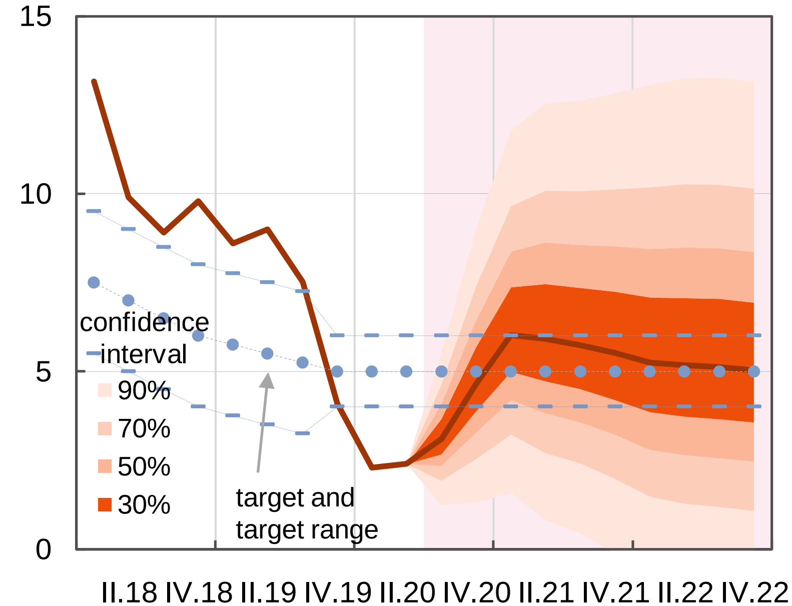
* [estimates based on old FDI methodology]
Source: SSSU, NBU, IR July 2020.

The key policy rate is expected to remain at the current low level at least until the end of this year

Key rate uncertainty, %



CPI uncertainty, %



Source: SSSU, NBU, IR July 2020.

- The key assumption underlying the macroeconomic forecast is that Ukraine's cooperation with the IMF will continue
- The main downside risk to the forecast is a longer-lasting coronavirus pandemic and the potential for a return to stricter quarantine measures

Risks

Influence on baseline	Risk probability: Low <15%	Risk probability: Middle 15%–25%	Risk probability: High 25%–50%
Weak	Higher volatility of global food prices		
Moderate	Lower harvest due to weather conditions		
Strong	Escalation of the military conflict in eastern Ukraine	Suspension of the cooperation with IMF Judicial decisions on the financial system	Longer-lasting coronavirus pandemic A deeper recession of the world economy A sharp increase in social standards

Key takeaways

- Ukraine entered the COVID-19 crisis with solid fundamentals – GDP growth was stable, inflation and the current account deficit were moderate, and the banking sector and public finances were healthy
- The key difference with previous crises is that there is an IT regime in place, resting on a floating exchange rate, which serves as a cushion against adverse shocks. As a result, this crisis has not been accompanied by devastating depreciation and skyrocketing inflation
- The economy was hit hard by the lockdowns, both domestic and abroad. Ukraine's real GDP decreased sharply in Q2, but will recover in H2 2020. Over 2020 as a whole, real GDP is forecast to decrease by 6%. In 2020-2021, GDP will grow by about 4%, buoyed by monetary and fiscal stimulus and rebounding external demand
- Inflation will rise gradually in H2 2020 and return to its target range of 5% ± 1 pp in Q4 2020, driven by the recovery of aggregate demand on the back of loose monetary and fiscal policies. Future NBU monetary policy will be directed at maintaining inflation within its target range
- Continued cooperation with the IMF remains the key assumption underlying the NBU macroeconomic forecast